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THE POLISH CAPITAL MARKET IN THE CONTEXT OF JOINING THE EUROPEAN UNION

The main purpose of this paper is to point out the consequences of joining the European Union for the Polish capital market. The author pays attention to the potential threats and opportunities accompanying the process of Polish capital market integration with EU15 markets, especially in the regulatory and competitive area.
Keywords: European integration, securities legislation, bond market, equity market

INTRODUCTION

The Polish capital market has changed dramatically since its creation in 1991. Nevertheless the market will continue to change, probably even faster than in the last decade of the 20th century. This is an effect of Poland's accession to the European Union to a large degree. The progression of financial market integration in the EU will create a new environment for the Polish capital market. The process of integration is a significant challenge both for Polish and other Central- and East European capital markets, especially considering that they are significantly less developed than the ones of the EU.

The main purpose of this paper is to point out the consequences of joining the European Union for the Polish capital market. By entering the European Union in 2004 Poland is poised to join sophisticated international markets. The process of integration of the Polish capital market with EU ones is an essential issue for all its participants in Poland, especially for the Securities Exchange Commission and the Warsaw Stock Exchange. The process of the EU directives implementation into Polish law and the harmonization of market rules and standards, both legislative and non-legislative, bring the Polish market closer to the European Union. Nevertheless, harmonization of rules is only one of the consequences of Poland's accession to the EU, and it is not the most important one. A much greater challenge lies in preparing all the participants of the Polish capital market for the increased competition within EU markets. A particularly

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important issue of the above mentioned is the fact that competitive pressure will be increased along with the progress of integration.

1. INTEGRATION OF EU CAPITAL MARKETS

Since the beginning of the 1980s the structure of European capital markets has changed significantly. This change can be attributed to the below mentioned factors (Dorn 1993; *Report...* 2001, p. 71):

- liberalization and deregulation of financial markets (particularly liberalization of capital flow),
- rapid development of technology,
- creation of European Monetary Union (EMU) and introduction of a single currency: the euro,
- capital market integration within the European Union.

Among the above mentioned factors, a special role in the development of European capital market in recent years has been played by the process of capital market integration within the European Union. The conditions in which the EU capital markets operate have changed systematically along with structural reforms accompanying the process of integration.

For many years the issues regarding capital markets integration have been left in the shade of other aspects of the integration of Europe. However, in the 1980s the situation changed a little. In 1985 the White Paper was published – a document putting forward a proposal of three hundred measures, the adoption of which should allow the completion of the single market (internal market) building process (*Timetable...* 1985). Some of these measures concerned capital markets (for instance the proposal referring prospectus, Undertakings for Collective Investment in Transferable Securities – UCITS, information published when major holdings in the capital of a listed company are acquired or disposed of). Although the date of the final adoption of all these measures was precisely fixed, capital markets integration in European Communities has been left behind. Not even the adoption of the Investment Services Directives (ISD) in 1993 substantially improved the conditions for providing investment services, as was expected beforehand (Official Journal 1993, L 141).

In the 1990s the process of EU capital markets integration was slow and not successful. However, the barriers arising within the integration process not only concerned the capital markets, but primarily all segments of the financial market. Accordingly, in the mid 1990s the European Commission

(EC) published a document entitled "Financial Services: Building a Framework for Action". In this document the EC paid attention both to the importance of financial services for the EU economy (financial services in EU represented about 6% of EU GDP and 2.45% of EU employment) and to the role of financial markets in capital allocation. At the same time the EC affirmed that the development of financial services in the context of integration process was still being left behind. So far the European Union has not created appropriate conditions to integrate the financial markets. Therefore the Member State countries have not yet benefited from proper functioning and transparent capital markets. To change this situation the European Commission has published a Financial Services Action Plan – FSAP (*Financial Services. Implementing...* 1999).

FSAP was adopted by the European Commission in May 1999 and was endorsed unanimously by all EU governments. It brought forward 42 separate measures (9 proposals for new Directives and 33 non-binding recommendations or amendments to existing legislation) designed to complete the legislative framework for the internal market in financial services (according to the tenth FSAP Progress Report of 2 June 2004 some 39 of 42 measures have been finalized, 1 is under negotiation and 2 proposals have to be made). Many of the FSAP measures concern the principles of European capital markets and investment firms functioning. Among other things those measures apply to (*The EU Financial...* 2003):

• securities issuance and trading (The Prospectus Directive, The Market Abuse Directive, Investment Services Directive etc),

• securities settlement (The Settlement Finality Directive, The Collateral Directive),

• accounting (The Fair Value Accounting Directive, The Accounting Modernization Directive, Introduction the obligation of applying International Accounting Standards from 2005 to all companies listed on EU exchanges),

• corporate restructuring (The European Company Statute, The Takeover Bids Directive, Modernization of 10th and 14th Company Law Directive).

The aim of FSAP was to allow the creation of a single market for financial services in the European Union by the adoption of all the measures. A kind of supplement to it, in the field of securities, was proposed by the Committee of Wise Men. In the report, published on 15 February 2001, the Committee proposed a new structure of European securities legislation – making it faster, more flexible, transparent, effective and responding to market development. New regulatory approach distinguishes four levels of the regulatory process. Legislation at level 1 should be based on framework principles. At level 2 all technical details of legislation adopted at level 1 should be worked out. Level 3 assumes strict cooperation between national regulators to improve implementation. In level 4 the Commission assesses the level of implementation adopted law to the national legislation and also checks compliance of national legislation to EU directives (*First Interim... 2003*, p. 6–7).

An important step towards the realization of Lamfalussy Report postulates was creating The European Securities Committee (ESC) and Committee of European Securities Regulators (CESR) as essential elements of the legislation process on 6 June 2001. The establishment of these committees follows the Resolution adopted by the European Council at the Stockholm Summit in 2001 (*Services Financiers...* 2001).

Most of the actions undertaken by the Member States towards the integration of capital and financial markets in the EU concern the legislative aspects of this process. Such attitude is an effect of the EU model of integration, which assumes the harmonization of minimum standards and mutual recognition. This concept has been forced and developed by the White Paper, published in 1985 (*Completing...* 1985), which laid down mutual recognition as a basis for single market legislation.

The European Union Members' determination in accelerating the process of capital market integration and financial market integration is motivated by the potential benefits attributed to this process, including a better performance of the EU economy. Integrated markets should allow to (*The EU Economy...* 2001, p. 125):

- increase the efficiency of investment (better portfolio diversification, enhanced investment quality, greater liquidity),
- obtain a better quality of financial services (new innovative services),
- reduce the costs of market functioning and market participants (integration of clearing and settlement systems, financial intermediaries competition).

These direct, positive effects of integration should lead to a creation of deep, efficient and liquid financial markets. Efficient market can be a motor for growth, employment and competitiveness of the EU economy.

Perhaps the scale of capital market integration process is not satisfactory, especially in the context of the creation of a single integrated financial market in the European Union, but it has been under progress. Despite all the arising problems and barriers there has been closer cooperation between particular capital markets and its participants in Member State countries since the late 90s. The best examples of such cooperation are: creation of the

Euronext first pan European exchange, consolidation of clearing and settlement infrastructures (e.g. Crest, Euroclear) and promotion of unified trading platforms (e.g. Xetra). This cooperation is a result of increasing competition and cost reduction pressure on capital markets rather than the efforts of the EU bodies in forcing the common rules of those markets functioning. Nevertheless, the creation of a common regulatory framework and common rules for all Member States will enhance the conditions of cross border transactions.

Some completely new challenges for the process of capital market integration arose from 1 May 2004 – the date of EU enlargement. These challenges, however, concern mostly the new Member State countries. Equally, the fifteen countries of the New Member States have to take responsibility for the future course of capital market integration process. Furthermore, the newcomers have to put a lot of effort into this process, especially in the context of preparation of their domestic markets to the increased requirements of the single market – both legislative and non-legislative resulting from increased competition. This is particularly difficult, taking into consideration the short time of capital markets functioning in Eastern and Central Europe countries and their level of development.

2. THE DEVELOPMENT OF THE POLISH CAPITAL MARKET

The Polish financial system, like most EU's Member systems, is bank driven (bank oriented). At the end of 2003, total banking system assets in Poland amounted to 60.8% of GDP and bank lending (credits to non-financial sector) to 26% of GDP (*Sytuacja...* 2004, p. 34). However, the capitalization of Warsaw Stock Exchange (WSE) represented only 17.3% of GDP and total amount of outstanding debt securities circulated around 33% of GDP (statistics for 2002). Banks are still the main source of external financing for enterprises in Poland. They also have the biggest share in the distribution of financial assets – 82% (in comparison – investment funds have 2% and pension funds have 3%) (Bednarski, Osiński 2002, p. 172). In EU15 countries the main source of financing are bank loans (109.6% of GDP in 2001), debt securities (amount of outstanding debt securities in 2002 represented 95.4% of GDP) and equity financing (market capitalization in 2002 – 58.5%). Although bank-based financing in the EU has been dominant in recent years, the market-based one has gained in importance (*Financial Integration...* 2004, p. 3-4).

Within the Polish capital market much attention is being paid to the equity market. Although this market, with capitalization amounting to 29.35 bln EUR at the end of 2003, is the largest market in Central and Eastern Europe (figure 1), it is still relatively small compared to the developed European capital markets. In terms of capitalization Warsaw Stock Exchange can only be comparable to Luxemburg Stock Exchange or Wiener Börse. The average capitalization of a single company listed on WSE is also small (155 million EUR), even compared to Central and Eastern Europe markets (Prague – 323 million EUR, Budapest – 259 million EUR, Vienna – 358 million EUR). Beside WSE, some companies are listed on the OTC market, organized and managed by CeTO company, however, the capitalization of this market reached only 0,04% of GDP in 2003 (*Strategia...* 2004, p. 18-19). Similarly, the value of share trading on WSE (according to World Federation of Exchanges statistics) – amounted to 7.96 billion EUR in 2003 – is relatively low, comparing to other European stock exchanges (Athen Stock Exchange – 34.87 billion EUR, HEX – 145.64 billion EUR and London Stock Exchange – 4.571,15 billion EUR). Significant growth of share trading value is expected in 2004, together with the public offer of the biggest Polish retail bank – PKO BP. Incomplete statistics for 2004 confirm this. The total share of trading value in 2004 (excluding December) amounted to 13.38 billion EUR.

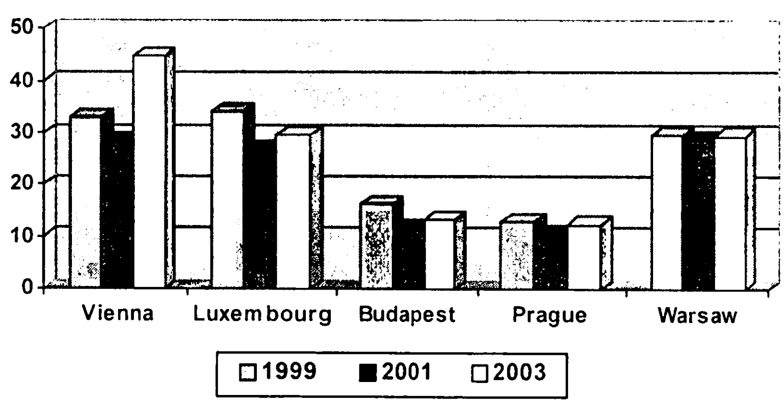

Figure 1. Market capitalization of selected European equity markets (billion EUR)

Source: Federation of European Exchanges (FESE), World Federation of Exchanges (WFE), Prague Stock Exchange, Budapest Stock Exchange

Despite the very fast development of the equity market in Poland since 1991, the number of companies listed on WSE has been changing in recent years, not showing a clear trend – 230 companies were listed in 2001, whilst in 2003 there were only 202. Due to bankruptcies and some companies' decision to withdraw their stock from public trading, 19 companies were delisted in 2003 (*Fact Book...* 2004, p. 19). However, the situation changed dramatically in 2004. The number of newly listed companies amounted to 36 (9 were delisted in the meantime) and the total number of companies listed on WSE increased to 230. It is estimated that the capital raised in 2004 amounts to over 2 billion EUR (Brycki 2004). To compare – in 1998 companies raised 862 million EUR, but 5 years later was about 333 million EUR (in 2002 only 149 million EUR) – WFE Statistics. Such recovery of Polish capital market in 2004 is attributed to the offer of the biggest products offered by bank in Poland – PKO BP, which – with a capitalization of about 5.93 billion EUR; is the biggest company listed on the Warsaw Stock Exchange (WSE Monthly... 2004, p. 3).

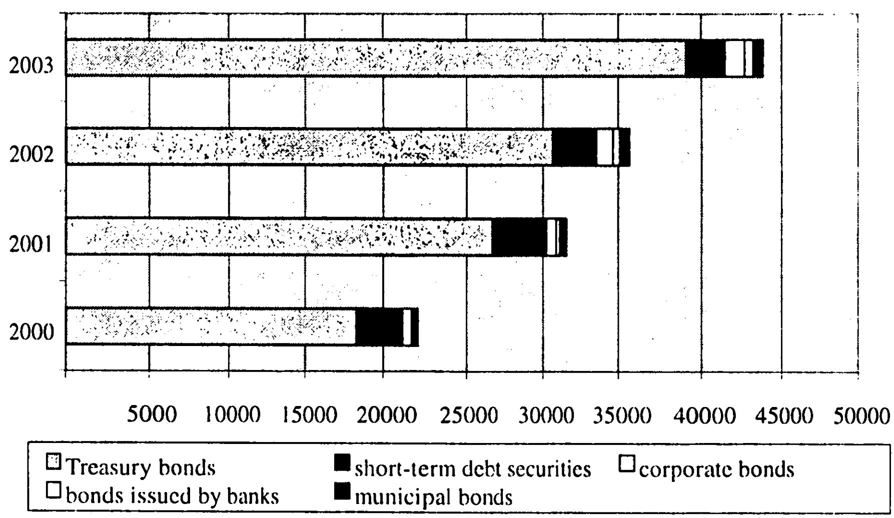

Figure 2. Amount of outstanding debt securities 2000-2003 in million EUR*
* Presented statistics include short term debt securities
Source: Fitch Poland, Report 2003

Another important segment of Polish capital market is the debt securities market. Traditionally the most active and dominant issuer of this segment is the government sector. According to the National Bank of Poland statistics the total amount of outstanding Treasury bonds at the end of 2003 amounted to 39,1 billion EUR (23% of GDP). The amount of outstanding government debt has increased significantly in recent years (about 90% between 2000 and 2003) as an effect of the increasing budget deficit. It is expected that this trend will continue within the next few years (*Strategia...* 2004, p. 22-23). The Treasury bonds represented about 94% of total bond issues in Poland and it is not expected that this share will change dramatically in the near future.

According to Fitch Poland statistics, the non-Treasury bond market in Poland only represents 2,7% of GDP. However, this segment of bond market increased significantly in 2003 (about 40% compared to 2002) and amounted to 2,27 billion EUR (figure 2). The main issuer, with a market share of more than 50% at the end of 2003, was corporate sector. Banks (519,18 million EUR) and local authorities (559,49 million EUR) were less active issuers. The majority of non-Treasury bonds were offered in a private placement – for instance, in 2003 only 11,6% of municipal bond issues was offered in a public placement. In 2004 the non-Treasury market continued to grow. The value of the market increased by about 35% - from 2,01 billion EUR in the third quarter of 2003 to 2,88 billion in the same period of 2004. The biggest growth was noted in the banking sector – the total amount of outstanding debt increased by more than half (54%).

The securities issued by the non-government sector are frequently purchased by banks and corporate sector. According to available statistics published by Fitch Poland, at the and of February 2004 the share of particular investors in purchasing new issues was as follows: banks – 48%, corporate sector – 32,51%, foreign investors – 4.98%, insurance companies – 3.89%, pension funds – 0,7% (*Polski rynek...* 2004).

The Polish debt securities market, which represents only 25.7% of GDP, is relatively small compared to other EU15 markets (Bond... 2003). This is particularly true for the corporate bond market. The outstanding amount of corporate bonds in Poland did not exceed 1% of GDP in 2003 (0,66%). In Germany – where companies are strongly dependent on bank financing – this indicator reached 6% (compared in France – 23% and in the UK – 26%). However the latter statistics include money market instruments and bonds (*Deutsche...* 2004, p. 16).

Although the Polish capital market has changed significantly since its creation in the early 1990s, it is still small and less developed than other European markets. Unfortunately the speed of its development has diminished dramatically in recent years, meaning that the disproportion between Polish and other capital markets could not decrease. Not only is this an effect of the poor performance of the Polish economy in 2000-2002, but also of other weaknesses of the Polish capital market. In particular these weaknesses result from (*Strategia*...2004, p. 38-41, Adamska 2003):

- low liquidity of stock market, mainly caused by the low level of free float and too high concentration of stock ownership,
- restrictive legal environment for institutional investors, which limits the investments on many capital market segments (for example venture capital),
- lack of small and medium enterprises interested in raising capital by issues of securities,
- long and very costly process of admission of securities to public trading,
- restrained process of state-owned companies privatization,
- increasing issues of Treasury securities which squeezes other securities issues.

These weaknesses have influenced the Polish capital market and its performance in recent years, especially in the period of 2001-2003. In particular the lack of supply of state-owned enterprises in that time, which has created demand in domestic market in the past, had a negative impact on the Polish capital market.

Despite arising problems, there were still many chances of changing the situation. Expected economic growth in forthcoming years, pressure on decreasing interest rates, increased asset value of institutional investors (especially pension funds) and the still significant pool of state-owned enterprises to be privatized are among the most important opportunities for the further development of the Polish capital market. It is worth noting that some of the above mentioned factors have already influenced the capital market in 2004, making it possible to overcome the recession noted at the beginning of the 21st century. The relatively fast development of the economy (estimated growth of GDP in 2004– 5,7%), acceleration of the privatization process and the good performance of world financial markets have, to a large extent, contributed to the accelerated development of Polish capital in 2004. It is important to underline that some opportunities can also arise directly from Poland's accession to the European Union.

3. THE CHALLENGES FOR THE POLISH CAPITAL MARKET ACCORDING TO EU ACCESSION

On 1 May 2004, Polish capital market became a part of the European capital market. The process of accession implies two basic consequences which are challenges for Poland: first – the necessity of adoption of common EU rules which determines the functioning of EU capital markets, second – the assurance of appropriate development and competitiveness of the domestic capital market. The latter is particularly important taking into consideration the weakness of the Polish capital market and the potential threats arising from the integration process.

The adoption of EU regulations concerning the capital market and its implementation to national law has been proceeding rather smoothly. The majority of the regulations were implemented to the Act on Public Trading in Securities of 21 August 1997. In 2001 amendments to the law came into force. The most important changes harmonizing Polish law with the appropriate EU regulations, include (*Annual Report...* 2001, p. 32):

- mutual recognition of prospectuses and admission of securities to public trading or trading in regulated markets,
- introduction of the single passport principle for investment firms,
- introduction of the principles of co-operation among Member States on exchange of information and on surveillance,
- introduction of compulsory participation of entities conducting brokerage activity in the investors' compensation scheme run by the National Depository of Securities,
- defining principles of organization of "official market", the introduction and supervision of which is obligatory for all Member States.

The above mentioned changes are only a part of the wide array of adjustments implemented into Polish law. Many of them, related directly to participation in the Single Market, have come into force at the moment of Poland's accession to the European Union.

In 2003, Polish Securities and Exchange Commission prepared a draft amendment to the Act on the Public Trading of Securities. The draft has introduced several significant changes harmonizing Polish law with EU directives as a result of (*Annual Report...* 2003, p. 20-21):

- Directive 2003/6/EC of the European Parliament and of the Council on insider dealing and market manipulation (Market Abuse Directive),

- Council Directive 93/22/EEC on investment services in the securities field (Investment Services Directive),
- Directive 2001/34/EC of the European Parliament and of the Council of 28May, 2001 on the admission of securities to official stock exchange listing and information to be published,
- Directive 92/51/EEC of the Council of 18June, 1992 on a second general system of the recognition of professional education and training supplement to Directive 89/48/EEC.

Other changes within Polish law in connection with Poland's accession to the EU concerned the Investment Funds Act of 28 August 1997, which specifies the principles for creating and operating of investment funds in Poland. The most significant changes concern (*Stan...* 2003, p. 21-23):

- mutual recognition of investment funds operating under the UCITS legislation,
- introduction of the possibility of creating a new type of investment fund – venture capital investment fund; umbrella funds, funds of funds,
- harmonization of investment limits with the limits resulting from the appropriate Directive,
- introduction of regulations concerning exchange of information between authorities supervising investment funds,
- simplification of the procedures of forming and operating of investment funds,
- enabling the distributing of open-end funds participation units in the Republic of Poland, carried out by investment fund corporations with the headquarters in the Member States or the member countries of the OECD, as well as regulating the rules of their distribution.

Enumerated amendments harmonize the Polish law with the appropriate EU directives on UCITS - Directive 2001/108/EC (Official Journal 2002, L 041) and Directive 2001/107/EC (Official Journal 2002, L 041) of the European Parliament, and of the Council of 21 January 2002 amending Council Directive 85/611/EEC.

The process of preparation of the Polish capital market for EU accession is a real challenge for Polish Securities and Exchanges Commission (PSEC), Ministry of Finance, Parliament and other market participants (for instance, National Depositary for Securities). However, the most active participants of this process are the Polish Securities and Exchanges Commission and the Ministry of Finance. The Office of the PSEC has prepared a regulatory work on the level of convergence of Polish regulation to the legal system of the

European Union in the area of capital markets. The work has mainly been focused on preparing drafts of amendments to the Act on the Public Trading in Securities and the Investment Funds Act. The Office has also prepared transposition tables with EU directives concerning capital markets (*Annual Report...* 2001, p. 78-79).

Although the Polish Securities and Exchanges Commission fulfill a significant role in the process of harmonization of Polish law with EU Directives, it is the Ministry of Finance which is responsible for the preparation of legislative measures concerning capital market and for their submission to the Polish Parliament. The Ministry of Finance played an important role, not only in the pre-accession period, but also after accession, because, since rules harmonization is a process, there are still many activities that need to be undertaken. New propositions of legislation prepared by the Ministry of Finance are under way. The Ministry has published proposals of the law on public offers and rules of financial instruments issuing, law on capital market supervision and other decrees concerning information requirements for publicly traded companies or the presentation of prospectuses and the information they contain.

The process of EU directives implementation into the Polish law is being controlled systematically. In October 2001 a review of operating principles of the institutions supervising the Polish financial market was conducted. One of the reviewed institutions was Polish Securities and Exchanges Commission. The results of this review were presented as a report to the European Commission (EC), describing the level of harmonization between the Polish and EU laws. The draft of this report was passed on to PSEC in June 2003 (a full report has been available since 2004). In July 2003 the EC submitted further remarks concerning necessary changes to be implemented into Polish law. Consequently an amendment to the Act on the Public Trading in Securities was prepared, including the regulations introduced in Directive 2003/6/EC on insider dealing and market manipulation (*Annual Report...* 2003, p. 39-40).

The harmonization of Polish capital market regulations with the appropriate EU directives is not the only consequence of Poland's accession to the EU. There are definitely many more challenges arising from the participation of Poland in the single financial market. Increasing competition within the single market can be a threat for the Polish capital market, still being small and less developed than the capital markets in other EU countries. Thus the potential benefits from the financial market integration within the European Union can be limited or reserved to a narrow group of capital market participants. Better conditions offered by the EU markets and the introduction of a single passport for issuers may cause a migration of the companies listed on the WSE to other markets. Being listed abroad, Polish companies gain the access to improved conditions of raising capital, together with the possibility to enlarge the investor base and to decrease the costs of listing (however one must be aware that in some cases these costs may be even higher) (Pagano et al 2001, p. 3-9).

The abundance of market segments offering different, often liberal, conditions of securities admission in the EU countries may attract Polish companies to list their shares abroad. The probability of running this scenario will rise owing to the increasing financial integration within the EU and the increasing level of competition among the capital market participants – especially stock exchanges and other trading systems. What is more, both the internationalization of Polish companies activities and increasing size of those companies can strengthen this probability (Pagano et al 2001, p. 3-9). The biggest companies listed on Warsaw Stock Exchange, and the potential candidates to migrate to the foreign exchanges, are: Bank PKO BP (5.93 billion EUR), TP S.A. (5.69 billion EUR), Bank PEKAO S.A. (5.00 billion EUR), PKN ORLEN S.A. (3.80 billion EUR) and Bank BPH S.A. (3.07 billion EUR). These companies delisting would decrease the capitalization of the Warsaw Stock Exchange by about 50% (WSE statistics). As a matter of fact, it is impossible to withdraw these companies in a short term, however, some of them can try to get single passport for issuers, allowing them to raise capital abroad. The first Polish company that got such a passport is TVN Television.

Assuming that total withdrawal of the biggest Polish companies from the domestic market is rather unlikely, cross listing can be more popular. In fact a few companies are already cross listed. For example, Poland's largest domestic telecommunications provider – TP S.A., issued the Global Deposit Receipts (GDR), currently listed on the London Stock Exchange. It is worth mentioning that in 1998, TPSA proposed the highest offer of the GDR on the LSE. The main goal of GDR issue was to create an international image for the company's products, services and financial instruments. Apart from TP S.A., several other Polish companies currently use the Global Depositary Receipt programs (for example, Bank BPH S.A, PEKAO S.A, PROKOM S.A.).

Cross listing of Polish companies has not dramatically changed the situation on the domestic market. For many companies listed abroad, the turnover on foreign stock exchanges is often smaller than the domestic one.

The presence of Polish companies on the London Stock Exchange, for example, has little impact on the domestic market turnover (Claessens et al 2003, p. 19-20).

Another menace to Polish capital market, resulting from Poland's accession to the EU to some extent, is the possibility of foreign investors withdrawing from the market. Poor range of securities offered, lack of blue chips and low liquidity of securities can strengthen this threat. According to the stock market, however, the share of foreign investors in total turnover has been constant in recent years – in 1999-2003 the market share ranged between 28% and 35%. Those indices may change in the future, provided that Polish companies decide to reach foreign investors in their domestic markets or international markets. This is essential for the equity markets, where the most important companies (the biggest 10) have been generating more than 70% of total turnover (*Fact Book*...2004). However, in the context of equity market high growth, a significant number of newly listed companies on the WSE in 2004 and very good predictions for 2005, foreign investors are not expected to withdraw from the Polish capital market or limit their investment in Poland.

One of the most important aspects of Polish capital market integration with the European market is the creation of an efficient and competitive market infrastructure. That problem mainly concerns the functioning of the National Depositary for Securities (NDS), responsible for clearing and settlement operations, and Warsaw Stock Exchange – the main institution listing Polish companies. Regarding the NDS and its role in providing the clearing and settlement services, two different scenarios are concerned. Firstly – the separation of NDS clearing and settlement activities, in the case of NDS deciding to provide its services on the EU basis. It could be an honest proposition for Polish investors going to invest abroad. However, it is possible that a better solution for a Polish investor would be to use the service of other clearing and settlement institutions, providing cross border services at a lower cost. The second scenario does not assume the separation of clearing and settlement, but the costs of NDS functioning rationalization. This factor is very important if the NDS wants to play a dominant role in the domestic market. In both scenarios, however, the fast privatization of NDS is postulated, which should have a positive impact on the flexibility of this institution (*Polski rynek*... 2004, p. 15-16).

Another important part of the Polish capital market infrastructure is the Warsaw Stock Exchange. Opinions that the future of Polish capital market is strictly connected with the future of WSE are often being raised, proving the significance of the WSE to the domestic market. This may be true to some extent. Although Warsaw Stock Exchange is the biggest stock exchange in Eastern and Central Europe (in terms of capitalization and turnover), it is still very small compared to the other stock exchanges in EU15. As a separate entity, the WSE has no chance to play a leading role in the European Union. Instead, if no action is taken, it can be marginalized, since there is a risk of the biggest issuers and companies withdrawing from the WSE. To counteract this danger the WSE needs a reliable and good strategy – especially in the near future. Some strategy propositions have appeared in recent years.

One of the propositions is to develop a close cooperation with a leading European stock exchange and determine precisely the character of this cooperation. There are many ways for stock exchanges to cooperate – e.g. in information dissemination, common trading platform, clearing and settlement, marketing etc. However, the biggest problem of this strategy is to find a cooperating stock exchange. For instance, Deutsche Börse and London Stock Exchange are not interested in linkages with smaller exchanges, such as the Warsaw Stock Exchange. They prefer to persuade the companies listed on these exchanges to list their stocks on DB or LSE (Claessens et al 2003, p. 26-27). Another attitude to linkages with other stock exchanges is represented by Euronext. This is especially important for Warsaw Stock Exchange. WSE uses a trading platform NSC (Nouveau Système de Cotation), created and developed by Paris Bourse. NSC system, currently owned by AtosEuronext, supports the trading activity of Euronext cash markets. The fact of using the same trading platform brought WSE and Euronext closer (both stock exchanges signed a cross-membership and cross-access agreement in February 2002). However, cooperation between the two stock exchanges has not deepened further since that time.

Another scenario for the WSE is to develop cooperation with stock exchanges with Eastern and Central Europe – mainly Prague and Budapest Stock Exchanges. Theoretically this scenario is possible, but there are also several reasons which make it hard to execute. First of all, the WSE is still not demutualized, which limits the possibilities of close cooperation and eventual merger. Secondly, to strengthen the position of the regional stock exchange it is necessary to cooperate with one of the leading stock exchanges in the EU. Even merged, all East and Central European stock exchanges would still be very small comparing to EU15 ones. What is more, the cooperation with the regional stock exchange may not arouse the interest of bigger entities (*Polski rynek...* 2004, p. 16-20).

The last, and very probable, scenario is pulling out from close involvement with a strategic partner and the independent existence of the WSE. The creation of a strong local capital market has many advantages. There is a group of small and medium enterprises (SME) interested in a well-functioning local exchange, as the companies are known only in their home country. Apart from that, SME prefer to issue securities in their home currency in order to avoid currency risk. It is also preferred by domestic investors (especially individual ones) (Köke, Schröeder 2002, p. 129-130). This situation will certainly change after Poland's joining the EMU, nevertheless, adoption of a single currency euro is not expected before 2007, or even 2010.

Regardless of the chosen strategy, it is essential to demutualize the Warsaw Stock Exchange. Demutualized stock exchanges can better response to the needs of its users and customers (particularly issuers and investors). A really important thing is that demutualization can enhance the ability of the WSE to react to competition from other exchanges or trading systems (Lee 2002). There is another reason making it important for the WSE – it will accelerate the adoption of a new strategy for WSE development and will make it easier to cooperate with other European stock exchanges. Although Polish authorities and the WSE are in the process of negotiating the terms of demutualization (in January 2005 the Ministry of Treasury are going to choose a privatization advisor), it is hard to predict the date that goal is achieved, especially considering that 2005 is the election year in Poland.

Undoubtedly there is a positive impact of integration on capital markets, but the redistribution of benefits arising from this process can be unequal. This is especially true for medium and small enterprises, very important elements for all developed economies. Compared to large international companies, it is less likely that SME derive benefits from capital market integration. In Poland the access of SME to the capital market is considerably limited. One of the postulated solutions to this problem is to develop an alternative to the stock exchange market – a specialized market for small and medium enterprises. Such a market should be characterized by lower (liberal) requirements, acceptable for these enterprises, especially in the context of the issuance costs (*Polski rynek...* 2004, p. 8-12). A similar model for such a market already exists in the United Kingdom – Alternative Investment Market (AIM). The creation of such a segment in Poland does not resolve all the problems with small and medium enterprises financing, but it would let the enterprises gain better opportunities to raise the capital needed.

Beside the development of a new segment for small and medium enterprises, another challenge Poland faces is to improve the conditions of high growth companies financing. One of the postulated solutions in this area is to strengthen the private equity market. Although the private equity investments have recently been higher in Poland than in some EU15 countries (i.e. Greece, Ireland, Austria and Portugal), many Polish high growth companies (especially hi-tech) did not have easy access to the capital they needed to start their business and to develop new, innovative ideas. As a matter of fact, private equity investments in Poland increased by about 37% in 2002 compared to 2001, and amounted to 137 million euros. Nevertheless, the value of these investments has only reached the level of 1998. The future of Polish private equity market is uncertain. This is caused by the absence of a favourable legislative system in Poland and the lack of public support and adequate policy of Polish authorities to a large degree (*Yearbook...* 2003). Moreover, the existing investment restrictions for Polish financial institutions – not willing to get involved in private equity and venture capital investments – limit the development of this market. This is especially true for pension funds. In 2003 the value of pension funds net assets exceeded 9,5 bln EUR. The investment portfolio of these institutions consisted of bonds in 59,41% and in 32,31% of equities (traded on the regulated, public market). Investments in pension funds on the private equity market would definitely have a positive impact on this market (*Open...* 2004, p. 3).

It is worth noting that similar problems with high growth companies financing have occurred in EU countries in recent years. However, to respond to all these problems the EU has adopted the Risk Capital Action Plan (RCAP). RCAP focused on legislative measures, the adoption of which allows to eliminate barriers, making risk capital markets integration and development impossible. These barriers were: market fragmentation, lack of a satisfactory regulatory framework, taxation and fiscal barriers, paucity of high tech SME and cultural barriers (*Communication...* 2001, *Risk...* 1998). All RCAP measures were adopted by 2003. The implementation of the Risk Capital Action Plan and the favourable economic environment (especially in 1999-2000), positively affected the development of the risk capital market in the European Union. In 2002, the total EU private equity, including venture capital and buy-out investment, amounted to 27 billion EUR (0,29% of GDP). In 2000 funds raised for private equity investment were even higher – 45,63 billion EUR (0,40% of GDP). Between 1998 and 2000 the market increased by about 132% (*Communication...* 2003).

To stimulate the development of Polish capital market and its integration with the EU structures, Poland has to draw up an appropriate strategy. A good example of such a strategy is the Strategy for Development of Polish Capital Market "Agenda Warsaw City 2010", drawn up and published by Ministry of Finance. The term of this strategy realization (2010) is not accidental – it covers the realization of the Lisbon Strategy. Agenda Warsaw City 2010 has outlined three strategic objectives (*Strategia...* 2004, p. 46-47):

1. to improve the stock market significance in the national economy by increasing the stock market capitalization to GDP (this indicator should reach in 2010 the minimum level of 50%), developing the bond market as a source of companies financing alternative to bank loans (the value of corporate bond market should reach 8% of GDP in 2010) and developing the venture capital market (0,25% of GDP in 2010),
2. to enhance the efficiency of the capital market by increased liquidity (turnover to capitalization should amount to 0,7-0,9% of GDP in 2010),
3. to improve the security of market participants and their confidence in the Polish capital market.

To achieve these goals it is necessary to undertake many different actions. According to the Strategy these actions were classified in four groups – legislative actions (simplification of existing rules, full implementation of EU directives, improvement of the competitiveness of Polish financial intermediaries), organizational actions (improvement of corporate governance rules, centralization of Treasury securities trading), infrastructure actions (creating a trading platform for high growth companies, reduction of the cost of capital market institutions functioning), privatization actions (privatization of state-owned enterprises).

The realization of these objectives is expected to take place in two phases. In the first phase (2004-2006) all actions covered by the Strategy should be undertaken. As a result, the Polish capital market should start to improve its performance (2007-2010) (*Strategia...* 2004, p. 46-47).

The Strategy "Agenda Warsaw City 2010" is one of the most important studies worked out in Poland and forced by Polish Authorities. In broad outline this study reminds the Financial Services Action Plan, adopted in 1999 by the European Commission, nevertheless, it is more vague than FSAP. The Strategy only draws up general actions and does not assume specific measures. The main objectives of the Strategy seem to be too ambitious and difficult to achieve. In addition, political uncertainty and frequent changes of Polish ministers whose competences cover capital market matters make the realization of the Strategy difficult. Despite all the arising obstacles there is a need to undertake fast and reasonable actions. The successful implementation of proper solutions, will enable the Polish capital market to deal with the above mentioned challenges and menaces.

4. CONCLUSIONS

The Polish capital market, set up in 1991, has significantly developed since the date of its creation. For all those years it played a very important role, especially in the privatization of state-owned enterprises. Many of them are currently listed on the Warsaw Stock Exchange, being the biggest and most liquid companies of the Polish capital market. Nevertheless, in recent years the development of this market has slowed down, especially between 2001-2003. The main reasons for this situation are: the worse performance of the Polish economy in recent years, the discontinuing process of privatization and not responding to the current needs of capital market regulation economy system. Fortunately in 2004 some positive signals of market development were noted. It seems that 2004 should be crucial for the development of the Polish capital market, especially the equity market. From the last few years, 2004 seems to be the best year with respect to market performance. WSE indexes were reaching the highest results (WIG and WIG20 indexes), market capitalization increased by more than 50% compared to 2003, there were 36 newly listed companies (including the privatized PKO BP bank). Additionally, high economy growth in 2004 (about 5.7%) added impetus to the Polish capital market. Despite the good results in 2004 and the good prospects for 2005, it is still necessary that some structural reforms of the Polish capital market (to improve its structure and competitiveness) are introduced. There are still many problems that need to be overcome in the process of the integration of the Polish capital market with the European market.

To strengthen the competitiveness of the Polish capital market, it is essential to focus on the elimination of its weaknesses. First of all, it is necessary to create the appropriate conditions for small and medium enterprises financing within the capital market. An introduction of a special segment, with a liberal admission criteria, would be a good solution in this context. Other postulated solutions are: demutualization of the Warsaw Stock Exchange, to make this institution more flexible and more competitive, development of the private equity market and lifting investment restrictions concerning institutional investors. All the above mentioned are presented in Agenda Warsaw City 2010 – Strategy for development of Polish capital markets. Of course, defining these postulates in the Strategy is not enough to realize them. Many strategies, including those worked out in Poland, were not realized in recent years and the main objectives were not achieved. In the case of Agenda Warsaw City 2010, it is also important to specify a particular action and departing from its general descriptions. This will allow to accelerate the realization of this strategy.

All actions and initiatives towards improving the performance of the Polish capital market should take into account the process of the European Union capital markets integration. Beside the necessity of harmonization of Polish law with EU directives, which is a direct consequence of Poland's accession to the EU, it also has to promote solutions allowing to reduce the cost of markets functioning and the cost of capital in Poland. Especially the relatively significant cost of capital in Poland may cause a shift of Polish issuers onto foreign markets.

All things considered, it is worth to note that the developed EU capital markets have problems similar to those of the Polish capital market. For example, despite the realization of the Risk Capital Action Plan, EU capital markets still do not respond accurately to the needs of SME, although significant progress has been noted in this area. Moreover, the still high cost of EU capital markets functioning and its infrastructure (for instance, clearing and settlement activities) make cross-border transactions within the EU difficult. That is important for the integration process and EU market competitiveness compared to the US. On balance, Poland should follow EU actions, however, not forgetting about promoting its own measures, responding to the Polish capital market and its participants needs.

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